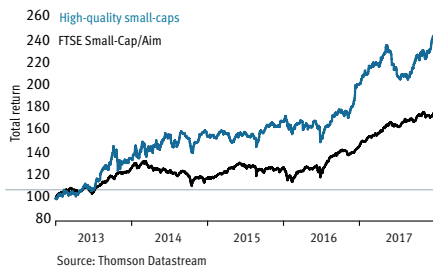




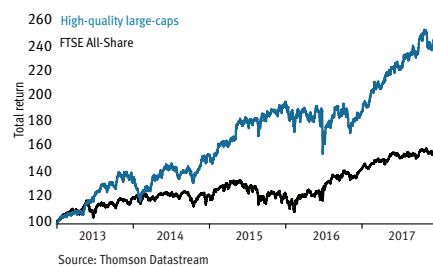
AlphaScreens: the quest for Quality

The holy grail for buy-and-hold investors is to find a business that is capable of generating a high return on its capital and sustaining it while reinvesting profits. This screen looks for shares that demonstrate these ‘quality’ characteristics and can deliver significant compounded returns over time

High-quality small-caps vs FTSE Small-Cap/Aim



High-quality large-caps vs FTSE All-Share



Screen criteria:

Our Alpha Quality screen uses two key measures of quality: operating margins and return on equity. We are mindful that debt can flatter a company’s return on equity, so we aim to reduce this risk from the screening results by introducing interest cover tests, to eliminate companies that are aggressively gearing up their balance sheet.

- There are 13 FTSE All-Share companies that pass all our quality screen tests this month. In addition, many of these companies have enjoyed strong three-month share price momentum, reflecting the popularity of quality companies. Only tobacco company **Imperial Brands (IMB)** has seen its share price fall (by 17.3 per cent) in the time.
- On a cautionary note, some of the gains enjoyed by undoubtedly high-quality companies means that once more their valuations are becoming stretched. For example, **Games Workshop (GAW)** is up 32.7 per cent in three months; engineering company **Spirax-Sarco (SPX)** is up 22.3 per cent and **Moneysupermarket.com (MONY)** is up 13.4 per cent.
- Seven Aim companies score full marks, but again it is worth reappraising the growth investment case behind momentum shares such as **Churchill China (CHH)**, **Gamma Communications (GAMA)** and **Water Intelligence (WATR)** at their current valuations. *JN*

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The dream company

The holy grail for buy-and-hold investors is to find a business that is capable of generating high returns on its capital and is able to reinvest all its profits for decades to come, while maintaining those returns. The compounding effect of such an investment is what every long-term investor's dreams should be made of. A company making a consistent 15 per cent post-tax return on its equity and reinvesting all its profits would experience a near-30-fold (28.6 to be precise) growth in its equity base over 25 years, and after 50 years it would be a mind-boggling 1,084 times bigger than when it started. For a patient investor convinced that they have found such a situation, valuation should not act as a major impediment to a purchase.

Unfortunately, this kind of dream company is extremely rare and stock screens are too crude to provide the depth of analysis needed to provide confidence that a business may be the real deal. In particular, it is inevitable that some of the shares highlighted by our Alpha Quality screen will be cyclical companies that are enjoying a good run rather than companies that are well placed to sustain high returns through many business cycles to come. What our screen does do, however, is attempt to find pointers for companies that may have the potential to go some way to filling the dream brief. What's more, buying shares in companies that look attractive based on quality metrics can often prove a profitable strategy, even if many of the shares picked fall short of the buy-and-hold ideal.

Alpha Quality screening criteria

The screen uses two key measures of quality, which are operating margins and return on equity (RoE). The advantage of using RoE to measure the quality of a company is that it focuses on the returns that are ultimately of most significance to shareholders – after-tax earnings. However, RoE can be boosted by a company if it increases the amount of debt it carries. That means a high and rising RoE can sometimes simply reflect a reduction in the quality of the company's balance sheet and little improvement, or even a deterioration, in the quality of its operations. The screen attempts to counter this with its interest cover test, which should help it avoid companies with very aggressively 'geared' balance sheets. Focusing on operating margins also provides an assessment of quality at the operating level – ie before the impact of debt.

- An operating margin higher than the median average (mid-ranking) stock in each of the past three years (ie quality that shows some signs of persistence).
- A return on equity (RoE) higher than the median average (mid-ranking) stock in each of the past three years (ie again, quality that shows some signs of persistence).
- RoE higher than it was two years ago (ie quality is improving as well as persistent).
- Operating margin higher than it was two years ago (ie quality is improving as well as persistent).
- A dividend-and-debt adjusted price/earnings growth (PEG) ratio below the top fifth of stocks screened (ie stocks must not be too egregiously expensive for the growth on offer).
- A price/earnings (PE) ratio above the bottom 10 per cent of stocks screened and below the top 10 per cent (ie not a suspiciously cheap or dangerously expensive valuation).
- Interest cover of more than five (ie high RoE is not overly dependent on the use of debt).
- Forecast earnings growth for each of the next two financial years.
- Positive forecast free cash flow.

The Alpha Quality screen is conducted separately on constituents of the FTSE All-Share, FTSE All-Small and FTSE Aim All-Share indices, with the results from each screen reported in separate tables.

Not many stocks pass such a stringent list of criteria. The ones that pass all the tests are listed at the top of the table, followed by those failing one test, then those failing two tests as detailed in the 'Tests passed' column. All stocks must pass the test for three-year, higher-than-average RoE and margin to feature in the table. While the primary ranking of the stocks is based on the number of tests they pass, inside each of these groupings stocks are ordered according to their attractiveness based on operating margin and three-month share price momentum.

Stock screen methodology formulated and explained by Algy Hall

Alpha Quality screen: large-cap results

Name	TIDM	Mkt cap	Price	Fwd NTM	PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net Cash/Debt(-)	Cur	Tests passed (out of 9)	Test failed
Games Workshop	LSE:GAW	£1,349m	4,150p	21	3.1%	3.1%	8.0%	4.7%	32.7%	25m	GBP	9	na
Spirax-Sarco Engineering	LSE:SPX	£5,982m	8,125p	31	1.2%	5.0%	7.3%	22.3%		-236m	GBP	9	na
Moneysupermarket.com PLC	LSE:MONY	£1,920m	358p	20	3.1%	5.5%	8.1%	13.4%		30m	GBP	9	na
PayPoint	LSE:PAY	£687m	1,018p	16	8.1%	1.3%	4.9%	12.7%		33m	GBP	9	na
MJ Gleeson	LSE:GLE	£462m	846p	14	3.8%	8.1%	10.2%	14.9%		28m	GBP	9	na
Diageo	LSE:DGE	£77,103m	3,246p	24	2.0%	9.2%	5.9%	7.4%		-10,577m	GBP	9	na
Unilever	LSE:ULVR	£120,464m	4,610p	20	2.9%	8.1%	8.9%	8.5%		-20,688m	EUR	9	na
Sirius Real Estate	LSE:SRE	£651m	64p	18	4.4%	8.1%	67.0%	2.6%		-323m	EUR	9	na
On the Beach	LSE:OTB	£604m	461p	19	0.7%	14.2%	18.1%	3.1%		86m	GBP	9	na
Polypipe c	LSE:PLP	£844m	424p	14	2.7%	8.6%	6.2%	4.9%		-165m	GBP	9	na
Domino's Pizza	LSE:DOM	£1,197m	260p	16	3.7%	4.7%	7.6%	3.4%		-203m	GBP	9	na
RELX	LSE:REL	£33,904m	1,742p	19	2.4%	7.9%	6.4%	1.4%		-6,267m	GBP	9	na
Imperial Brands	LSE:IMB	£20,526m	2,165p	8	8.7%	3.8%	3.4%	-17.3%		-12,807m	GBP	9	na
Rightmove	LSE:RMV	£4,940m	557p	28	1.2%	10.0%	9.0%	16.4%		7m	GBP	8	/RoE grth/
Medica	LSE:MGP	£167m	150p	18	1.5%	6.9%	12.0%	33.2%		1m	GBP	8	/RoE grth/
FDM	LSE:FDM	£1,071m	989p	26	3.1%	6.4%	7.3%	20.5%		34m	GBP	8	/Int Cov/
XP Power	LSE:XPP	£481m	2,510p	14	3.4%	2.6%	6.4%	20.2%		-52m	GBP	8	/FCF/
Halma	LSE:HLMA	£6,655m	1,756p	33	0.8%	12.5%	7.9%	16.4%		-195m	GBP	8	/PE/
Experian	LSE:EXPN	£19,669m	2,183p	27	1.6%	2.8%	10.8%	8.3%		-3,430m	USD	8	/Marg grth/
Diploma	LSE:DPLM	£1,732m	1,530p	24	1.7%	9.5%	5.1%	13.9%		22m	GBP	8	/Int Cov/
HomeServe	LSE:HSV	£3,561m	1,071p	28	1.8%	8.7%	9.5%	11.3%		-292m	GBP	8	/RoE grth/
AG Barr	LSE:BAG	£928m	821p	25	2.0%	4.3%	4.5%	9.6%		22m	GBP	8	/RoE grth/
Barratt Developments	LSE:BDEV	£6,098m	602p	9	7.4%	4.6%	-0.8%	5.2%		379m	GBP	8	/Fwd EPS grth/
Bellway	LSE:BWY	£3,650m	2,965p	7	4.8%	3.5%	1.6%	4.3%		-27m	GBP	8	/RoE grth/
Reckitt Benckiser	LSE:RB.	£43,503m	6,145p	18	2.8%	1.5%	5.9%	1.5%		-10,421m	GBP	8	/RoE grth/
Ashtead	LSE:AHT	£9,466m	2,028p	10	1.6%	36.5%	11.0%	0.7%		-3,725m	GBP	8	/RoE grth/
Countryside Properties	LSE:CSP	£1,425m	319p	8	3.4%	12.0%	10.5%	1.7%		45m	GBP	8	/RoE grth/
Photo-Me International	LSE:PHTM	£353m	93p	10	9.0%	-4.7%	10.7%	-0.2%		31m	GBP	8	/Fwd EPS grth/
Croda International	LSE:CRDA	£6,470m	5,070p	25	1.8%	5.0%	7.0%	-2.2%		-426m	GBP	8	/RoE grth/
Smiths	LSE:SMIN	£5,933m	1,499p	15	3.0%	6.5%	9.3%	-0.2%		-938m	GBP	8	/RoE grth/
Ten Entertainment	LSE:TEG	£147m	227p	11	4.9%	26.0%	11.9%	-1.7%		-11m	GBP	8	/RoE grth/
Intertek	LSE:ITRK	£8,246m	5,124p	25	1.9%	5.4%	7.4%	-1.9%		-778m	GBP	8	/RoE grth/
Burberry	LSE:BRBY	£7,850m	1,922p	23	2.1%	-1.1%	3.3%	-3.5%		647m	GBP	8	/Fwd EPS grth/
Polymetal International	LSE:POLY	£3,650m	776p	9	4.7%	8.0%	6.1%	-10.1%		-1,520m	USD	8	/RoE grth/
Redrow	LSE:RDW	£1,987m	578p	6	5.3%	3.4%	4.0%	-6.9%		101m	GBP	8	/RoE grth/
Mondi	LSE:MNDI	£8,029m	1,658p	10	4.0%	-3.1%	3.6%	-12.3%		-2,218m	EUR	8	/Fwd EPS grth/
Tarsus	LSE:TRS	£386m	315p	11	3.5%	63.9%	-28.7%	19.1%		-81m	GBP	7	/Fwd EPS grth/Int Cov/
NEXT	LSE:NXT	£7,374m	5,626p	13	2.9%	2.8%	3.5%	13.0%		-1,135m	GBP	7	/RoE grth/Marg grth/
The Sage Group	LSE:SGE	£7,768m	715p	24	2.3%	-6.3%	8.7%	9.1%		-649m	GBP	7	/PEG/Fwd EPS grth/
Smith & Nephew	LSE:SN.	£14,079m	1,612p	21	1.7%	-0.3%	7.2%	10.1%		-1,103m	USD	7	/RoE grth/Fwd EPS grth/
Taylor Wimpey	LSE:TW.	£5,787m	177p	9	10.3%	-2.8%	1.7%	5.4%		617m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£251m	408p	25	1.6%	-25.6%	20.9%	3.3%		17m	GBP	7	/PEG/Fwd EPS grth/
Howden Joinery	LSE:HWDN	£3,136m	519p	15	2.2%	5.8%	7.3%	3.1%		231m	GBP	7	/RoE grth/Int Cov/
Merlin Entertainments	LSE:MERL	£3,778m	369p	18	2.2%	-9.2%	12.6%	1.5%		-1,190m	GBP	7	/RoE grth/Fwd EPS grth/
IMI	LSE:IMI	£2,660m	983p	14	4.1%	-	-	2.4%		-401m	GBP	7	/Marg grth/Fwd EPS grth/
United Utilities	LSE:UU.	£5,436m	797p	14	5.0%	19.7%	4.3%	-1.8%		-7,447m	GBP	7	/RoE grth/Int Cov/
GlaxoSmithKline	LSE:GSK	£74,304m	1,502p	13	5.3%	-6.7%	4.7%	-2.4%		-27,544m	GBP	7	/Fwd EPS grth/FCF/
Victrex	LSE:VCT	£1,914m	2,220p	18	6.4%	-3.4%	5.6%	-6.7%		49m	GBP	7	/Fwd EPS grth/Int Cov/
Alfa Financial Software	LSE:ALFA	£385m	128p	20	-	3.8%	9.5%	-7.6%		45m	GBP	7	/Marg grth/Int Cov/
NMC Health	LSE:NMC	£5,505m	2,638p	22	0.7%	33.1%	19.2%	-4.8%		-1,552m	USD	7	/RoE grth/Int Cov/
Ferrexpo	LSE:FXPO	£1,256m	214p	4	9.5%	31.3%	-13.0%	-16.9%		-339m	USD	7	/RoE grth/Fwd EPS grth/
Persimmon	LSE:PSN	£6,628m	2,095p	7	11.2%	-1.5%	1.7%	-15.0%		1,048m	GBP	7	/PEG/Fwd EPS grth/

Source: S&P CapitalIQ, 13 May 2019

Alpha Quality screen: small-cap results

Name	TIDM	Mkt cap	Price	Fwd NTM	PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-)	Cur	Tests passed (out of 9)	Test failed
PayPoint	LSE:PAY	£687m	1,018p	16	8.1%	1.3%	4.9%	12.7%		33m	GBP	9	na
MJ Gleeson	LSE:GLE	£462m	846p	14	3.8%	8.1%	10.2%	14.9%		28m	GBP	9	na
Sirius Real Estate	LSE:SRE	£651m	64p	18	4.4%	8.1%	67.0%	2.6%		-323m	EUR	9	na
On the Beach	LSE:OTB	£604m	461p	19	0.7%	14.2%	18.1%	3.1%		86m	GBP	9	na
Medica	LSE:MGP	£167m	150p	18	1.5%	6.9%	12.0%	33.2%		1m	GBP	8	/RoE grth/
XP Power	LSE:XPP	£481m	2,510p	14	3.4%	2.6%	6.4%	20.2%		-52m	GBP	8	/FCF/
Henry Boot	LSE:BOOT	£354m	267p	10	3.4%	-4.9%	2.0%	6.8%		-18m	GBP	8	/Fwd EPS grth/
Photo-Me Intl	LSE:PHTM	£353m	93p	10	9.0%	-4.7%	10.7%	-0.2%		31m	GBP	8	/Fwd EPS grth/
Ten Entertainment	LSE:TEG	£147m	227p	11	4.9%	26.0%	11.9%	-1.7%		-11m	GBP	8	/RoE grth/
Treant	LSE:TET	£236m	403p	23	1.3%	1.4%	5.2%	-3.1%		9m	GBP	8	/RoE grth/
Tarsus	LSE:TRS	£386m	315p	11	3.5%	63.9%	-28.7%	19.1%		-81m	GBP	7	/Fwd EPS grth/Int Cov/
Picton Property Inc	LSE:PCPN	£504m	94p	22	3.7%	3.1%	1.8%	6.5%		-173m	GBP	7	/RoE grth/Int Cov/
Avon Rubber	LSE:AVON	£438m	1,434p	19	1.1%	-1.2%	4.6%	11.3%		47m	GBP	7	/RoE grth/Fwd EPS grth/
Aptitude Software	LSE:APTD	£251m	408p	25	1.6%	-25.6%	20.9%	3.3%		17m	GBP	7	/PEG/Fwd EPS grth/
Alfa Financial S'ware	LSE:ALFA	£385m	128p	20	-	3.8%	9.5%	-7.6%		45m	GBP	7	/Marg grth/Int Cov/
Vp	LSE:VP.	£291m	735p	8	3.5%	15.7%	6.0%	-28.1%		-188m	GBP	7	/RoE grth/FCF/

Source: S&P CapitalIQ, 13 May 2019

Alpha Quality screen: Aim results

Name	TIDM	Mkt cap	Price	Fwd NTM PE	DY	Fwd EPS grth FY+1	Fwd EPS grth FY+2	3-mth momentum	Net cash/debt(-)	Cur	Tests passed (out of 9)	Test failed
Churchill China	AIM:CHH	£175m	1,600p	22	1.8%	4.8%	10.0%	32.4%	17m	GBP	9	na
Gamma Communications	AIM:GAMA	£1,025m	1,090p	31	0.9%	17.1%	11.9%	37.4%	31m	GBP	9	na
Bioventix	AIM:BVXP	£198m	3,850p	34	3.1%	4.4%	12.0%	12.9%	5m	GBP	9	na
Water Intelligence	AIM:WATR	£54m	378p	32	-	25.4%	10.6%	28.1%	3m	USD	9	na
Somero Enterprises	AIM:SOM	£204m	363p	12	4.0%	5.7%	1.9%	7.4%	28m	USD	9	na
Johnson Service	AIM:JSG	£544m	148p	15	2.1%	6.4%	4.5%	12.5%	-99m	GBP	9	na
The Character Group	AIM:CCT	£120m	570p	12	4.6%	6.6%	10.9%	4.4%	20m	GBP	9	na
The Property Franchise Group	AIM:TPFG	£43m	168p	13	5.0%	0.8%	5.1%	38.8%	2m	GBP	8	/RoE grth/
D4t4 Solutions	AIM:D4T4	£101m	257p	19	1.0%	20.8%	-0.1%	31.3%	12m	GBP	8	/Fwd EPS grth/
Arcontech	AIM:ARC	£20m	155p	24	0.8%	54.8%	3.4%	28.9%	3m	GBP	8	/Int Cov/
Scientific Digital Imaging	AIM:SDI	£57m	59p	23	-	3.9%	29.2%	47.0%	1m	GBP	8	/RoE grth/
Belvoir Lettings	AIM:BLV	£42m	120p	10	6.0%	6.8%	13.4%	22.2%	-10m	GBP	8	/FCF/
Nichols	AIM:NICL	£679m	1,840p	25	2.1%	4.9%	4.9%	19.7%	39m	GBP	8	/RoE grth/
Elecosoft	AIM:ELCO	£69m	85p	19	0.8%	14.7%	10.9%	16.3%	-2m	GBP	8	/RoE grth/
Oxford Metrics	AIM:OMG	£122m	98p	27	1.5%	2.5%	30.9%	15.7%	12m	GBP	8	/RoE grth/
dotdigital	AIM:DOTD	£287m	97p	24	0.7%	18.8%	10.9%	9.1%	17m	GBP	8	/Int Cov/
Fevertree Drinks	AIM:FEVR	£3,542m	3,050p	50	0.5%	14.6%	13.1%	6.7%	84m	GBP	8	/PEG/
Tracsis	AIM:TRCS	£195m	680p	25	0.2%	5.0%	7.5%	8.4%	18m	GBP	8	/PEG/
Dewhurst	AIM:DWHT	£71m	1,060p	15	1.2%	37.2%	2.2%	16.7%	9m	GBP	8	/RoE grth/
AdEPT Telecom	AIM:ADT	£85m	360p	12	2.7%	7.3%	7.8%	12.1%	-31m	GBP	8	/Int Cov/
Portmeirion	AIM:PMP	£129m	1,215p	16	3.1%	7.4%	5.1%	14.5%	2m	GBP	8	/RoE grth/
Scapa	AIM:SCPA	£568m	367p	19	0.7%	-2.6%	22.0%	13.3%	-6m	GBP	8	/Fwd EPS grth/
IG Design	AIM:IGR	£469m	598p	22	1.1%	23.6%	13.8%	9.5%	-100m	GBP	8	/FCF/
iomart	AIM:IOM	£390m	359p	18	2.7%	6.0%	7.9%	-3.9%	-33m	GBP	8	/RoE grth/
Serica Energy	AIM:SQZ	£319m	120p	3	-	298.5%	-15.3%	-9.5%	35m	USD	8	/Fwd EPS grth/
Central Asia Metals	AIM:CAML	£392m	229p	9	6.3%	10.0%	16.0%	-10.1%	-110m	USD	8	/RoE grth/
ECO Animal Health	AIM:EAH	£277m	410p	17	2.2%	22.6%	7.4%	-14.5%	25m	GBP	8	/Int Cov/
Quixant	AIM:QXT	£169m	254p	13	1.2%	1.8%	11.7%	-16.6%	10m	USD	8	/RoE grth/
Pennant International	AIM:PEN	£40m	110p	12	-	3.0%	8.3%	-20.0%	2m	GBP	8	/Marg grth/
Redde	AIM:REDD	£363m	118p	9	9.8%	10.2%	-4.7%	-33.9%	-41m	GBP	8	/Fwd EPS grth/
AB Dynamics	AIM:ABDP	£467m	2,375p	44	0.2%	42.9%	14.4%	56.2%	19m	GBP	7	/Int Cov/PE/
SafeCharge International	AIM:SCH	£505m	332p	21	4.2%	22.0%	12.4%	21.2%	93m	USD	7	/RoE grth/Int Cov/
Andrews Sykes	AIM:ASY	£259m	615p	-	3.9%	-	-	15.3%	23m	GBP	7	/RoE grth/Fwd EPS grth/
Keystone Law	AIM:KEYS	£150m	480p	34	0.5%	14.3%	16.6%	27.7%	6m	GBP	7	/RoE grth/Marg grth/
boohoo	AIM:BOO	£2,832m	244p	48	-	21.1%	21.4%	26.9%	191m	GBP	7	/RoE grth/PE/
Craneware	AIM:CRW	£729m	2,770p	53	0.9%	14.9%	16.9%	7.8%	39m	USD	7	/Int Cov/PE/
M Winkworth	AIM:WINK	£15m	120p	13	6.3%	4.9%	6.1%	8.6%	3m	GBP	7	/Marg grth/Int Cov/
James Halstead	AIM:JHD	£1,068m	513p	27	2.6%	7.6%	2.7%	9.3%	63m	GBP	7	/RoE grth/Int Cov/
Secure Income REIT	AIM:SIR	£1,317m	408p	25	3.2%	13.0%	3.4%	3.4%	-1,007m	GBP	7	/RoE grth/Int Cov/
Tristel	AIM:TSTL	£141m	318p	31	1.4%	39.2%	12.0%	8.5%	4m	GBP	7	/RoE grth/Int Cov/
Dart Group	AIM:DTG	£1,392m	936p	10	0.8%	51.8%	-14.4%	16.7%	460m	GBP	7	/Fwd EPS grth/FCF/
Hotel Chocolat	AIM:HOTC	£401m	355p	38	0.6%	3.6%	14.0%	12.3%	22m	GBP	7	/PEG/RoE grth/
Prime People	AIM:PRP	£10m	82p	-	6.1%	-	-	10.1%	2m	GBP	7	/Fwd EPS grth/Int Cov/
Inspiration Healthcare	AIM:IHC	£21m	67p	19	-	2.9%	19.2%	10.7%	3m	GBP	7	/FCF/Int Cov/
ULS Technology	AIM:ULS	£42m	65p	10	3.7%	-11.1%	0.1%	1.6%	-3m	GBP	7	/PEG/Fwd EPS grth/
Gateley (Holdings)	AIM:GTLY	£177m	160p	13	4.4%	22.0%	7.1%	-9.2%	-8m	GBP	7	/RoE grth/Marg grth/
Fulcrum Utility Services	AIM:FCRM	£67m	30p	8	6.9%	1.4%	-8.1%	-43.8%	10m	GBP	7	/RoE grth/Fwd EPS grth/

Source: S&P CapitalIQ, 13 May 2019

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